MACROECONOMIC POLICIES IN INDONESIA

INDONESIA ECONOMY SINCE THE ASIAN FINANCIAL CRISIS OF 1997

EDITED BY ANWAR NASUTION

ROUTLEDGE

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Macroeconomic Policies in Indonesia

This book gives insight on the dynamics and route of economic policies that have been taken and implemented since the point of institutional reforms in 1998, which were triggered from the context of the financial crisis in 1997/1998. The condition brought a different paradigm to the landscape of economic and development policies, especially in the case of the monetary and financial structure, the international trade sector, the manufacturing sector, the taxes administration policy and the evolved context of decentralization and development of public sector policies in general.

Given the state of current economic development, this book offers suggestions to address economic issues that require improvements. This book is unique as: (1) it is about Indonesia, a country mostly affected by the 1997/1998 financial crisis, which also led to a change in regime; (2) it covers a broad range of thematic topics on sectors of development and institutional changes from major policies that have been taken; and (3) it posits both existing and future challenges on monetary and financial sectors, trade, manufacturing and competitiveness, as well as on development of decentralization policies.

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Contents

Introduction

This book identifies progress in some aspects of institutional reforms introduced in Indonesia after the end of President Suharto's 32-year period of administration in February 1998, particularly in the economics field. It offers suggestions to address economic issues that require improvements. In general, the reforms replaced a military-led authoritarian political system with a democratic multi-party system and a centralized government with broad-based decentralization and state-led economic policies with a market-based and more globalized open system. In contrast to most of the countries that give autonomy to provincial and state levels of the government, the autonomy in Indonesia is transferred to the regency or district at the sub-provincial level.

Indonesia was one of the main victims of the Asian Financial Crisis in 1997. The economy that had respectable growth at an average of 7 per cent per annum before the crisis between 1990 and 1996 sharply shrank to minus 13.1 per cent in 1998. During the same period, the inflation rate rose from 6 per cent to 60 per cent while the interest rate rose from 14 per cent to 63 per cent. The external value of the Rupiah devalued from Rp2,300 per US dollar before the crisis to Rp10,261 in 2001. These combinations had caused solvency problems for banks and the corporate sector particularly those that had great exposures to foreign debt.

As phrased in Chapter 3 the banking industry is the core of the financial system of Indonesia and a large portion of investment is financed through bank credit. The non-bank financial institutions, such as insurance and pension funds, had been growing fast since 2000, but their share in the financial industry remained limited. The Post Office has not been developed to become a narrow bank, mobilizing small savings and selling insurance policies to the masses. The mobilized funds can be used to absorb the Rupiah-denominated SUN (*Surat Utang Negara*) or sovereign bonds, SBI (*Sertifikat Bank Indonesia*) or Bank Indonesia's Certificates and equities traded in the Jakarta Stock Exchange.

The financial crisis in 1997 had impaired banks' balance sheets and their ability to lend. Such a crisis was costly to clean up due to the fiscal cost of recapitalization and purchases of non-performing assets of domestic banks. This reduction in fiscal space and deleveraging by the banking sector reduced both private and public investment which lead to slower economic growth, rising unemployment and further deterioration of asset quality. These deteriorated tax bases caused forgone tax revenue and ultimately a larger fiscal burden.

The Indonesian economy quickly recovered due to deep devaluation and rising prices of energy, food and primary products. Since 2000, the economy had been growing between 6 to 7 per cent per annum, benefiting from three booms. The first boom had been the boom in international prices of primary products. The rapid growth in China and India, between 9 to 10 per cent per annum, as well as the mechanization, motorization and urbanization in these rapidly growing economies, demanded energy and raw materials exported from Indonesia. The more affluent consumers in these rapidly growing economies also demanded better quality of foods, among others, marine and agriculture products from Indonesia. Second, there were remittances from low-skilled and uneducated labor working overseas particularly in the Middle East, Malaysia and Hong Kong. The third boom was the massive capital inflows to take benefit of high domestic interest rates in Indonesia, particularly after the quantitative easing or massive liquidity injections in the US between 2007 and 2011.

In the past two or three decades, East and South East Asian countries have been a large manufacturing hub where industrial spare parts and components are produced, making the region an important player of the global supply chain. Indonesia, however, fails to participate in the process. This is mainly due to a combination of bottlenecks, high cost of logistics and the appreciation of the Rupiah. The bottlenecks include the shortage of infrastructure and complicated investment regulations and business climate. A poor legal system and weak economic institutions have made it difficult to protect property rights, correct market failures and government failures. The strong external value of the Rupiah since the year 2000 occurred due to the boom in the primary products, labor remittances and inflow of short-term capital inflows. The stronger external value of the Rupiah erodes financial incentives for producers of traded goods and export. As a result, the structure of the Indonesian economy at present is not significantly changed from those during the colonial past. Indonesia remains to be a supplier of raw materials and a cheap unskilled and uneducated workforce.

The move to a market-based economic system was encouraged by the IMF and World Bank programs to rebuild the economy from the deep crisis in 1997. The programs consist of the short-run economic stabilization program and medium- to long-term structural program. The IMF short-term program consists of monetary and fiscal policies. It replaced the government-led or repressed macroeconomic policy that had been applied during the 32-period of President Suharto's administration between 1966 and 1998. The main elements of the economic policy before the crisis include: (1) the 'balanced budget rule', (2) fixed exchange rate, (3) repressed financial system and (4) distorted trade policy because of wide practices of corruption, collusion and nepotism. The winners in business competition are not necessarily the most efficient but rather the most politically connected. In the repressed financial system, Bank Indonesia, the central bank, set detailed credit ceilings, credit allocations by economic sector and class of customers, provided refinancing and credit guarantees and heavily subsidized interest rates.

In spite of various reforms, tax ratio or the ratio of government tax revenue to GDP remains very low around 13 per cent. This is mainly because of the weaknesses in tax administration that implements the reforms. Tax audit for example is only done internally by the Directorate General of Taxation. Audit by external auditors such as the State Audit Board requires permission from the Minister of Finance. As expected, self-assessment without auditing gives a license for tax evasion. Much of the evasion in Indonesia occurs on types of income that are difficult to monitor such as self-employment income, bad administration and transfer pricing by large companies that have branches and subsidiaries in neighboring countries such as Singapore with lower tax rates. Tax reform of December 1983 unifies and simplifies the personal and corporate income tax systems, simplifies reductions and exemptions, reduces tax brackets into three groups (15, 25 and 35 per cent), modernizes tax administration and shifts it to self-assessment. The value-added tax with a single rate of 10 per cent was introduced in April 1985 to replace the complicated indirect and sales taxes. In 2002 the Directorate General of Taxation established large taxpayer offices in cities such as Jakarta, Medan, Bandung, Surabaya and Makassar (Brondolo). To improve customs clearance, the government, between 1985–70, brought in a privately owned Swiss firm, SGS (*Societe General de Surveillance*) to provide custom clearance for shipments valued above $5,000.

For 32 years of President Suharto's administration, the entire budget deficit was financed by official development aid (ODA) from Indonesia's consortium of international donors (IGGI, the Inter-Governmental Group on Indonesia). Such budget debt rules were called 'balanced budget policy' and government revenue from foreign aid and loans was called development revenue that was earmarked for development expenditures. In 1998, the government started to issue sovereign bonds both to recapitalize the financially ailing banks and to finance the budget deficit. To prevent 'the original sins' the bonds are mainly denominated in domestic currency and sold in the domestic market. The securities are shielded from currency crisis but not from interest rate risks. In 2004 the government started to float sovereign bonds denominated in the US dollar sold in international markets. In 2009 the authorities issued the Samurai bonds partly guaranteed by the Japanese government.

The new short-run macroeconomic policy under the IMF Program of 1997–2003 replaces the fixed exchange rate system with a floating one and set inflation targeting as its new target and uses interest rates as its operating target. Modeled after the Bundesbank of Germany, Bank Indonesia is given an independent status, banned from buying government bonds in the primary market and the only objective of its monetary policy is to achieve an inflation target at a low rate. During the Suharto era, Bank Indonesia was supervised by the Monetary Board chaired by the Minister of Finance. The monetary policy adopted since 1997 is supported by fiscal policy that uses strict fiscal rules of the Maastricht Stability Rule of the European Union. The fiscal rule set a ceiling of both central and local governments' budget deficit to 3 per cent of annual GDP and Regional Domestic Product. The debt rule sets the ratio of public debt to GDP at a sustainable level of 60 per cent. The new budget and debt rules replace the previous 'balanced budget' rule and the debt rule of maximizing the ODA.

The central bank sets the reference or policy real interest rate lower than the neutral rate to stimulate the economy to full employment level. On the other hand, it sets the policy real interest rate above the neutral rate to dampen economic growth and avoid overheating. The difference between the actual policy rate and the neutral interest rate is called the interest rate gap. Aside from the interest rate gap, the monetary stance is also determined by the output gap, namely the difference between actual output and potential output. Interest rates should be reduced when real GDP fall below its potential.

In theory, Bank Indonesia needs a smaller amount of foreign exchange reserve as it has shifted its monetary policy to floating exchange rates and inflation targeting. The need for market intervention is reduced under a floating system as an exchange rate target is no longer used as a nominal anchor for monetary policy. The need for self-insurance is also reduced with the availability of loan backup after the revision of the IMF conditionality, multilateralization of the Chiang Mai Initiative and bilateral currency swap agreements between central banks in this region. Indonesia and other Asian countries accumulated large international reserves following the Asian financial crisis in 1997–98 (Ruiz-Arranz and Zavadjil, 2008) for a number of reasons. First, to avoid extreme fluctuations of the exchange rate and thus prevent adverse impacts on the economy. Second, to hedge against speculations and foreign exchange instability due to shortfalls in exports and capital flow reversals. Third, to maintain adequate fiscal space when facing economic crisis. Asian countries, including Indonesia, are reluctant to turn to the IMF for help, because they were treated improperly when they sought help during the crisis in 1997–98.

The progress of the economic reforms has been relatively slow to take benefit of political democratization, local autonomy and economic globalization. This is because of the slow progress in rebuilding the required institutions and degradation of quality of human resources that are needed to design policies and implement them. The current weaknesses in public institutions are particularly evident in three areas. First, poor legal and accounting systems that raise transaction costs as they cannot properly protect property rights and enforce contracts to make the economy more productive. This is also evident from the spread of corruptive practices in three branches of the government: executive, legislative and judiciary and in all layers from the top to the lowest level. The cost of market transactions is high because the legal system cannot protect property rights. As the system is perceived to be slow, conflicted people resort to debt collectors, thugs and take the law to themselves. Second and third are, respectively, the existence of market and government failures.

The Bank Bali scandal in 1999 and the Bank Century scandal in 2008 indicate the failures of Bank Indonesia (BI) as the bank's regulator and supervisor to implement prudential rules and regulations as well as its independency status. Pressed by the ruling government, Bank Indonesia gave its blessing to illegitimate claims of payments to Bank Bali from the Bank Restructuring Agency (IBRA) in 1999. Without having adequate capital and properly checking the integrity of the owners and management, BI gave permission to three small banks to merge and form Bank Century in December 2009. The bank is a small-sized bank and collapsed because of violation of prudential rules and regulations including legal lending limits and other criminal acts such as outright theft of its customers' deposits by the controlling owners of the bank. BI assigned an onsite supervisor at the bank, but did nothing to the various violations of prudential rules and regulations until the bailout in 2008. Without a proper license, the bank acted as a custodian to PT Antaboga, an unlicensed Trust Fund Company owned by one of the controlling owners who had a bad reputation. Like any other Indonesian bank, Bank Century was not a player in the US prime mortgages. The contagious effect of the bank's failings should have been contained because of its small size. The facilities to help address the liquidity and solvency problems of the bank were designed in a rush by BI. At the end, Bank Century was taken over by the state-sponsored LPS (*Lembaga Penjamin Simpanan*), the Deposit Insurance Company.

The decentralization or local autonomy program gives freedom to local governments at regency or sub-province level to set the size and structure of their budgets to deliver a variety of public services such as primary education, health care, local infrastructure. Taxing power, however, remains at the central government while local governments are only given rights to collect minor taxes. Collecting land and property taxes, for example, is still in the hands of the central authorities even though the country is rapidly urbanizing where over 49.4 per cent of its population in 2011 was living in big cities. This means that wealth is increasingly vested and locked up in land and property. The low municipal revenue-to-GDP ratio, at less than 1 per cent, indicates that urban tax and property are still untapped.

At present, the central government transfers two kinds of revenue to the local government, namely, general allocation (DAU-*Dana Alokasi Umum*) and revenue sharing (DBH-*Dana Bagi Hasil*) from general tax revenues and revenues from exploitation of natural resources. Some areas receive revenue sharing for reforestation. Special allocation funds or *Dana Alokasi Khusus* (DAK) are given to finance central government initiatives implemented by the region, particularly in remote and less developed areas. In 2012, over 39 per cent of central government expenditure was transferred to regions, mainly regencies and cities. The large vertical imbalance inherent in the massive mismatch between functions and finances of local governments, particularly urban local bodies, violates the principle of 'subsidiary' that is the cornerstone of fiscal autonomy.

As shown by Ing et. al in Chapter 7, the dilution of power because of democracy and decentralization of the government make the decision-making process more difficult. In contrast to the centralized system under the previous authoritarian regime, the decision makers under the present messy democracy have to accommodate interests of conflicting political parties and districts. Technical capabilities of the Parliament and political parties are insufficient to meet the rising law making and oversight responsibilities. Most of the districts do not have technical staff to implement the newly obtained power. Because of the high transportation costs and the lack of infrastructure, Indonesia has no integrated national market that takes benefits from its large population (2011: 242.3 million). Markets for goods and services and factors of production such as labor and financial markets are segmented across regional markets. The eastern parts of Sumatra and provinces in Kalimantan remain the hinterlands to supply both unprocessed raw materials and cheap labor to their neighboring countries, particularly Malaysia and Singapore.

The reforms gradually replaced the quota and non-tariff barriers with tariffs and at the same time reduced the level of tariff rates. Business licenses and investment climates have been slightly improved to attract private sector investment. Nevertheless, logistic costs remain high in Indonesia, partly because of infrastructure bottlenecks including electricity, roads and seaports.

The government failures are reflected in the inefficiency of state-owned enterprises, including the state-owned and regional development banks (RDB). This group of public sector banks enjoys monopoly rights to deposit financial wealth of the public sector at large, including state-owned enterprises. This unfair competition has caused segmentation in the financial market. Among the ASEAN5 countries (Thailand, Malaysia, Singapore, Brunei Darussalam and the Philippines), the net interest margin (NIM) or the gap between lending and deposit rates is the highest in Indonesia. NIM at state and RDB banks is the highest among the domestic banks.

The lack of well-developed economic institutions and high dependency of foreign financing have added to fragility in the economy. Over one third of the Rupiah-denominated SUN, SBI and equities traded in the Jakarta Stock Exchange is owned by foreign investors. This makes their prices and yields sensitive to movement of capital flows. At the same time the flows also affect the exchange rate and interest rate. Capital inflows increase prices of domestic equities and subsequently increase capital as well as assets of their holders including recapitalized banks that received capital injection in the form of government bonds in 1998. The rise in banks' capital reduces the ratio of their dud loans or the non-performing loans (NPL). Capital outflows reduce prices of equities that erode values of capital and assets of the recapitalized banks and increase their NPL. Kenward (Chapter 3) shows that the crises in the mutual fund industry in 2003 and 2005 were because of the sudden massive capital outflows.

This book is a collaborative effort by faculty members and researchers from the Faculty of Economics, University of Indonesia, and foreign researchers that had been working on Indonesia. The writers have benefited from two public seminars held in Jakarta in September 2011 and February 2012. The purpose of the book is to enrich a public discussion of macroeconomic formulation, implementation and evaluation in this country. We look forward to continuing our joint efforts to improve future economic management in a more democratic and decentralized Indonesia.

Jakarta, 5 August 2014
Anwar Nasution
The Editor

1 Towards a market-based monetary policy

Anwar Nasution

I. Introduction

This chapter discusses the formulation of monetary policy since the financial crisis in 1997–98. Special attention is given to how monetary policy instruments developed following the shift of economic management in 1997 from direct government control to a market-based system. The tools of monetary policy give the central bank a commanding position in respect of money supply. In the present market-based system, Bank Indonesia uses interest rate as the operating target of monetary policy. The central bank sets the real interest rate level neutral if the monetary policy is neither expansionary nor contractionary. The neutral or equilibrium interest rate depicts stable inflation with a closed output gap over the medium term. The central bank sets the real interest rate lower than the neutral rate to stimulate the economy to full employment level. On the other hand, the central bank sets the real interest rate above the neutral rate to dampen economic growth. The difference between actual policy rate and the neutral real interest rate is called interest rate gap that can be used to evaluate the monetary stance to close the output gap.

The use of interest rates as the operating target of monetary policy requires a set of pre-conditions. First, the existence of a financially healthy banking system and deep well-developed money and capital markets which are not sensitive to the vagaries of short-term capital flows. The underdevelopment of the money and capital markets in Indonesia is partly because of the long period of financial repression prior to banking sector reform that began in October 1988 and continued up to the crisis in 1997. During that era, there was no need to issue short-term Treasury bills or SPN (*Surat Perbendaharaan Negara*) or long-term government bonds (SUN or *Surat Utang Negara*) as the government budget deficit was entirely financed by official development aid (ODA) from a consortium of foreign creditors. Domestic business sector is either owned by the state or tightly close family-owned that are reluctant to either issue bonds or equity shares for raising capital. During the past financial repression, the financing of long-term business sector investment was provided by the credit programs of the state-owned bank with both low interest rates and credit risks.

Second, the existence of a competitive, effective and efficient financial market characterized by low transaction costs. Such a market will only exist in the absence of discrimination as regards bank ownership, and based on good legal and accounting systems that protect private property rights, enforce contracts and ensure symmetric transmission of information. At present, the banking system is segmented because the government deposited its financial wealth only at state-owned banks. Meanwhile, the private banks are more interested in financing their business affiliates. The system also requires good supervision of the financial system with prompt and strict implementation that is equally applied to all financial institutions, including state-owned banks and non-bank financial institutions (NBFIs). The third requirement is the existence of sound non-inflationary monetary policy, exchange rate policy, fiscal discipline and sustainable public debt management policies to promote both short-run macroeconomic stability and long-term economic growth so as to allow the financial system and business sector to flourish and avoid crisis. Lastly, the availability of up-to-date and reliable information on the banking system's liquidity position – the supply and demand for reserve balances.

As noted in the previous chapter, three major policy instruments are now being used to preserve financial stability. First, upgrading prudential supervision and regulation of the banking and financial systems so as to bring them into line with the Basel Accords. For this, Indonesia has increased the risk-weighted capital ratio to above the 8 per cent required by Basel I and has implemented the Core Principles for Effective Banking Supervision. To comply with Basel II, Indonesia has moved from a practice of supervision based on compliance-checking towards the implementation of risk-oriented procedures. Second, building up external reserves at times of high commodity prices and short-term capital inflows. Third, establishing deposit insurance and a financial system stability forum to facilitate better coordination between the central bank, Treasury, Deposit Insurance Company and the Financial Sector Supervisory Authority including for resolution of bank failures.

In an open economy the central bank can use macroeconomic prudential policies as complementary tools to conventional monetary policy or substitute to conventional interest rate policy. Surges in capital inflow, for example, have expansionary effects on money supply and credit. On the other hand, during the period of positive terms of trade shock and surges of capital inflows, the central bank can use the macro prudential policies to tighten its credit or monetary stance without altering policy rate.

The rest of this chapter is divided into eight sections. Section 2 discusses the new monetary and fiscal rules first introduced under the IMF program in 1997 and which are still being used today. Section 3 analyzes the accumulation of external reserve policy introduced following the crisis in 1997. Section 4 describes the new role of Bank Indonesia, the central bank, following the crisis in 1997–98. Section 5 analyzes the shift in monetary rule from quantity rule to interest rate rule. Section 6 evaluates the operational implementation of Inflation Targeting and the Taylor Rule in Indonesia. Section 7 analyzes the monetary